

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:

, ID No.
Telephone Number:

Refer Reply To:
CC:PSI:B01
PLR-149762-09
Date:
April 22, 2010

LEGEND

X =

State =

Date1 =

Date2 =

Date3 =

Date4 =

Date5 =

a =

b =

Year 1 =

Year 2 =

Year3 =

Year4 =

Year5 =

Dear _____ :

This responds to a letter dated _____, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting inadvertent invalid election relief and inadvertent termination relief under § 1362(f) of the Internal Revenue Code.

Facts

According to the information submitted, X was incorporated under the laws of State on Date1. X elected to be treated as an S corporation for Federal tax purposes effective Date2. At that time, X had two classes of stock outstanding, which conferred disparate preemptive rights. The preemptive rights were never exercised or exercisable, and on Date4, X amended its articles of incorporation to eliminate the preemptive rights.

Also at the time of the S election, X had C corporation accumulated earnings and profits ("CE&P") of \$a. For each of the consecutive years of Year1, Year2, and Year3, X had passive investment income in excess of 25 percent of its yearly gross receipts. As a result, X's S election would have terminated on Date3 if it had been valid.

In the course of preparation for X's Year4 tax return, X became aware that its S election had terminated on Date3. To correct the error, X made an election under § 1.1368-1(f) of the Income Tax Regulations to treat all Year4 distributions as dividends paid from X's accumulated CE&P. X represents that in Year5, X distributed as dividends the remainder of its accumulated CE&P.

X represents that the circumstances resulting in the potential invalidity of its S election, as well as the termination on Date3, were inadvertent, and that since Date2 X and its shareholders have filed returns consistent with X's status as an S corporation (other than with respect to its passive investment income and the tax under § 1375). X and its shareholders agree to make adjustments (consistent with the treatment of X as an S corporation) as might be required by the Secretary.

Rulings Requested

1. To the extent that X's S corporation election on Date2 was ineffective, X requests a ruling under § 1362(f) that X will be treated as being an S corporation beginning on Date2 and thereafter;

2. X requests a ruling that the termination of its S election on Date3 will be treated as an inadvertent termination under § 1362(f).

Law and Analysis

Section 1361(a)(1) provides that the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1) defines a “small business corporation” as a domestic corporation which is not an ineligible corporation which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, and a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(d)(3)(A)(i) provides that an election under § 1362(a) shall be terminated whenever the corporation has accumulated earnings and profits at the close of each of three consecutive taxable years, and has gross receipts for each of such years more than 25 percent of which are passive investment income. Section 1362(d)(3)(A)(ii) provides that any termination under § 1362(d)(3) shall be effective on and after the first day of the first taxable year beginning after the third consecutive taxable year referred to in § 1362(d)(3)(A)(i).

Section 1362(f) provides that if (1) an election under § 1362(a) by any corporation (A) was not effective for the taxable year for which it was made (determined without regard to § 1362(b)(2)) by reason of a failure to meet the requirements of § 1361(b) or to obtain shareholder consents, or (B) was terminated under § 1362(d)(2) or (3), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the event resulting in the ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make such adjustments (consistent with the treatment of the

corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Section 1368(c) provides rules for determining the source of distributions made by an S corporation having accumulated earnings and profits with respect to its stock. Section 1368(e)(3) and § 1.1368-1(f)(2) provide that an S corporation may, with the consent of all its affected shareholders, elect to distribute earnings and profits first.

Section 1.1368-1(f)(3) provides that an S corporation may elect to distribute all or part of its accumulated earnings and profits through a deemed dividend. If an S corporation makes the election provided in § 1.1368-1(f)(3), the S corporation will be considered to have made the election under § 1368(e)(3) and § 1.1368-1(f)(2) to distribute earnings and profits first.

Section 1375 imposes a tax on the income of an S corporation that has accumulated earnings and profits at the close of a taxable year, and that has gross receipts more than 25 percent of which are passive income (within the meaning of § 1362(d)(3)).

Conclusion

Based solely on the information submitted and the representations made, we conclude that, to the extent the shares of X subject to the preemptive right constitute a second class of stock, any invalidity of X's S election as a result of the preemptive right constitutes an inadvertent invalidity within the meaning of § 1362(f).

Furthermore, we conclude that X's S corporation election, if valid, would have terminated on Date3 under § 1362(d)(3)(A) because X had earnings and profits at the close of each of three taxable years, and had gross receipts for each of those taxable years more than 25 percent of which were passive investment income. We also conclude that this termination of X's S election on Date3 was an inadvertent termination within the meaning of § 1362(f).

Therefore, we conclude that X will be treated as an S corporation from Date2 and thereafter, including on and after Date3, provided that X's S corporation election was otherwise valid and was not otherwise terminated under § 1362(d). This letter ruling is subject to the following condition: as an adjustment under § 1362(f)(4), a payment of \$b and a copy of this letter must be sent to the following address: Internal Revenue Service, Cincinnati Service Center, 201 West Rivercenter Blvd., Covington KY 41011, Stop 31, Terri Lackey, Manual Deposit. This payment must be sent no later than Date5. If this condition is not met, then this ruling is null and void. Furthermore, if this condition

is not met, X must send notification that its S election has terminated to the service center with which X's S election was filed.

Except as specifically set forth above, no opinion is expressed concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, no opinion is expressed regarding X's eligibility to be an S corporation or the validity of its S corporation election. Further, no opinion is expressed as to whether X's income was passive investment income under § 1362(d)(3)(C).

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X.

Sincerely,

/s/

David R. Haglund
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter
Copy of this letter for § 6110 purposes

cc: